

# TOUCHSTONE

## The Future of Super

July 2010

*The Final Report of the Super System Review (the “Cooper Review”) was released earlier this month. It is a comprehensive report which contains a number of well-reasoned suggestions for change. Further, it has been a catalyst for the examination of many sensible industry requests some of which have been ignored by government and regulators over the last decade.*

*Not surprisingly, many areas are covered in fine detail with comprehensive recommendations for implementation; other areas are quite shallow and several parts suffer from poor analysis based on inadequate research. Given the strength of submissions and extensive consultation from the superannuation industry, we are very disappointed at a number of ill-founded or weak conclusions. In this edition of **Touchstone**, we set out our own recommendations to show how Cooper can be amended to deliver a better outcome.*

*The government will have to be selective in carefully adopting the Cooper recommendations. However, there is no doubt that, with sensible modifications, this review can be a catalyst for major change and better outcomes for members.*

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### Structure of Cooper’s Final Report

The final report of the Super System Review was released this month. The Report supersedes the four preliminary reports released since December 2009.

It is a lengthy document in two Parts. The first (158 pages) has an overview and sets out 177 recommendations over 55 pages. The second part (330 pages) puts the recommendations into ten packages where there is a background description leading to each recommendation. These packages are grouped as follows:

- MySuper and Choice Architecture (28 recommendations)
- Trustee Governance (20)
- Investment Governance (6)
- Outcomes Transparency (20)
- Insurance in Superannuation (16)
- Integrity of the System (18)
- Retirement (4)
- Self-managed Super solutions (29)
- SuperStream (17)
- Regulatory Settings (19)

While the above sectors are set out in separate chapters of the report, they are not self-contained. For example, there are recommendations relating to investments in several chapters. There is no attempt to list the recommendations in order of priority or materiality. In addition to the recommendations, there are a number of suggestions for matters requiring further review.

## Architecture

The industry has developed into three broad segments which have many common features but also several different ones. The three broad segments are:

- Not-for-Profit funds (industry, public sector and corporate);
- Commercial funds (master trusts and wraps provided by financial institutions); and
- Self-managed superannuation funds (SMSFs).

These segments vary primarily by distribution system and offer different pricing models and member services. All are well established with well over \$300 billion of assets each. We set out the characteristics of each in our first submission to the Cooper Review<sup>1</sup>.

A key theme of the Review's recommendations has been to reorganise the population of superannuation members into three distinct product groups and to tailor the rules to suit each group. It recommends a basic product, "*MySuper*", for the 80% of Australians deemed to be "disengaged members". Its theme is to produce a no-frills cheap product which will have a sound investment strategy chosen by the trustee. This is intended to provide good value without the member needing to take any personal interest or seek advice on their retirement strategy.

Trustees could offer other options for members under a "*Choice*" product (similar to most industry fund structures today). Finally, those who want to be self-reliant could set up a self managed superannuation fund (SMSF).

Under this structure, members will be placed as follows:

- **Disengaged members** - they will enter **MySuper**, a low-cost simple product with no investment choice;
- **Engaged members** - they will be shifted into a **Choice** product with a wider range of options; and
- **Controlling members** - they will manage their own arrangements in an **SMSF**.

While the composition of an SMSF product is largely unchanged, the Not-for-Profit and Commercial segments will blend together and each will be able to offer a MySuper and a Choice product.

It is proposed to run these segments under common superannuation law but each will have its own rules. For example, employers will be required, as part of their SG obligations, to use a MySuper product as a default fund for their employees.

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<sup>1</sup> Phase One - Governance - see [http://www.ricewarner.com/images/newsroom/1256529916\\_Cooper%20Review%20Part%20One%20Governance.PDF](http://www.ricewarner.com/images/newsroom/1256529916_Cooper%20Review%20Part%20One%20Governance.PDF)

### *MySuper Architecture*

The key objective of MySuper appears to be to provide a good value product for the disengaged masses. The Review intends to drive down the costs within the industry by prescribing the features of MySuper. Some features are deliberately more restrictive in an effort to save costs:

- No commissions (which is already Government policy as set out by Minister Chris Bowen in his Future of Financial Advice (FOFA) statement following the Ripoll enquiry);
- Single investment strategy (no choice of investment options within this product);
- New standards on performance fees for investment contracts;
- No entry or exit fees (except for cost recovery);
- Mandatory intra-fund advice (even though members are disengaged);
- No advice from or payments to financial planners unless the member has an individual contract with a planner (in which case they are not disengaged);
- Mandatory insurance for death and TPD (“opt-out” basis);
- Members (presumably those who are merely partly disengaged) could opt for higher levels of insurance within the MySuper account;
- Optional income protection insurance at the discretion of trustees;
- No commissions on insurance products;
- Mandatory retirement income-stream product (requiring a high level of engagement);
- Provision of Benefit Projections in lump sum and income form (without considering the Age Pension);
- The product must have sufficient scale to be viable (as determined by APRA);
- There cannot be any cross-subsidisation between MySuper and other accounts (and this will be audited); and
- Members could have some of their super in MySuper and the rest in a Choice account (which means they are then engaged members using a MySuper account).

Finally, in conjunction with MySuper, the Review has recommended the end of:

- Member Protection;<sup>2</sup>
- Retirement Savings Accounts; and
- Approved Deposit Funds.

Curiously, the Review saw a need to retain Eligible Retirement Funds. In a properly structured system with solid rules for SuperStream, this anachronism would definitely not be required. Presumably it would be retained as a transitional arrangement only and would be phased out eventually.

### *Choice Architecture*

Choice accounts would be very similar to industry fund products today. These accounts would have many of the same criteria as MySuper but would also provide access to an expanded investment menu (similar to those available within an industry fund).

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<sup>2</sup> Despite this, automatic account consolidation is not recommended - see comments under SuperStream.

Members could choose to be “undiversified” and trustees would not be responsible for their investment choices. This is presumably structured to allow platforms to provide wide ranges of investment options whilst providing a “safe harbour” for trustees so they could avoid potential civil liability from members.

The choice would not be unlimited like a modern retail platform as there are some restrictions. For example, all options should have reasonable liquidity.

### *Self-Managed Super Funds*

Ironically, when the Review was first announced, a major part of its investigation was related to the SMSF segment. The proposed changes are relatively benign, perhaps reflecting that several members of the Panel have an SMSF and they consider the segment to be operating efficiently. They do suggest outlawing collectibles and in-house assets to remove assets which could be non-income producing but make few other major changes.

There are a number of recommendations which have the effect of giving the ATO powers of enforcement in respect of an SMSF very similar to those in other tax areas. There are recommendations to tighten the requirements for SMSF auditors, to scrap the accountants’ exemption from licensing and to introduce higher RG146 standards for advisers to an SMSF.

The light treatment of the SMSF segment is incongruous given the heavy-handed approach to APRA-approved funds. While the Review is obsessed with ensuring that members are provided with good value, they appear to have reasoned that people setting up an SMSF are capable of taking care of their own arrangements and need little protection. Yet, we know that at least one third of SMSF funds are sub-scale and most members have undiversified investment portfolios - with no requirement to seek advice or provide a formal structured investment strategy.

For several years, there has been concern within the industry that many Australians are attracted to setting up an SMSF even where it is not the optimum outcome for their superannuation. Whilst the review has recommended training for trustees, the continued lack of integration with APRA rules will create an arbitrage opportunity for institutions and intermediaries to promote SMSF structures for those members with the most at stake - those with high balances.

### Proposed Structure

Under Cooper, the industry will end up with three distinct product segments with these characteristics:

Item	MySuper	Choice	SMSF
Governance	Trustee sets product parameters.	Member has some choice within parameters set by trustee.	Full member control.
Investments	Single Option.	Multiple options (set by trustee)	At member discretion.
Insurance	Default cover compulsory (“opt-out” basis). Also allows voluntary additional cover (even though these members are all disengaged!).	Default cover desirable (but not compulsory) with allowance for voluntary additional cover.	None unless maintaining additional account with APRA fund (or buying retail insurance).

	Income Protection is optional.	Income Protection is optional.	
Fees	Slightly lower than the fees of large industry funds.	Additional fee of 20 to 50 basis points above MySuper is likely.	No change.
Distribution	Primarily via Award Modernisation.	Intermediaries within retail sector or direct to large customer bases (for example, banks).	Open slather - but mainly accountants and financial advisers.
Reserves	Minimum of 50 basis points likely.	Higher reserves will be needed.	N/A
Advice	Mandatory pro-active intra-fund advice. Members can authorise trustee to deduct fee for personal advice provided by an intermediary.	Mandatory pro-active intra-fund advice. Members can authorise trustee to deduct fee for personal advice provided by an intermediary.	Optional at discretion of members.
Retirement	Trustee must consider income stream to cover longevity and inflation issues.	Trustee must consider income stream to cover longevity and inflation issues.	Strategy is managed by members.

As can be seen, MySuper is little different from the Choice product in practice. The key differentiator (apart from the lack of any investment choice) is the attempt to remove costs associated with engagement (marketing, advice, complicated servicing, etc) and limit or remove subsidies from small, less active accounts to larger, more active accounts.

MySuper is very similar to the default structure of an industry fund today - but without access to a range of investment options. Despite the argument that it is for disengaged members (the majority), it is mandatory to provide intra-fund advice *proactively* in all important areas, which will be costly. Further, these members can apply for additional insurance (but they cannot choose an investment option!).

### *Modifications to MySuper*

It is important to ensure the underlying product architecture is correct or we will simply lurch from one set of inefficiencies into another. The name "MySuper" has the connotation of being chosen by the individual (which the Review brands as a Choice account). Consequently the name is not accurate. For this reason an alternative name should be chosen that is more closely aligned to the intent of the product.

A Choice account should not cost too much more than a MySuper account. Funds would need to charge a reasonable additional fee for the extra services, but not so much as to outweigh the extra value to members.

The product design could be improved quite easily - MySuper should cater exclusively for SG-only members utilising the standard default investment and insurance benefits (with no income protection cover). The prime role of a MySuper account is to capture the SG contributions of disengaged members - from all their various workplaces. Despite silence from Cooper, the design would then allow full account consolidation as well as being the catalyst for the SG being paid on all wages - even those earning less than \$450 a month!

As soon as a member becomes engaged to the extent of making adjustments to their superannuation provision they should be moved to the Choice segment. For instance, as soon as a member pays additional contributions or takes out additional insurance, they should be moved to the Choice segment. They need not vary their investment strategy but they will then have the facility to do so.

As soon as a MySuper member acts on intra-fund advice, they should be transferred to a Choice account.

Similarly, all pensioners should be deemed to be Choice members (or they would have simply taken a lump sum at retirement).

## SuperStream

Another key recommendation is to enforce electronic commerce within superannuation. SuperStream has been a key objective of the industry for at least a decade. The proposal has been developed by the industry and is well presented by the Review.

Cooper has taken up industry requests (ignored previously by government) to use the Tax File Number (TFN) as the identifier to link members (and employees) with their fund. The Privacy Commissioner has given tentative approval to use the TFN for superannuation purposes.

Importantly, employers will be forced to submit accurate data on behalf of their employees as part of their SG obligation. This will cut the costs of collecting and allocating contributions in some sectors, particularly industry funds.

Clearing Houses will be expected to transfer money to funds within two working days. This will reduce the cash float which is a significant source of their fees at present.

Importantly, the review missed the opportunity to enforce automatic consolidation of member accounts. It does recommend allowing a trustee to do this within a fund which seems to be pretty obvious (and most funds should be doing this already). It also permits funds to use data supplied by the ATO to promote consolidation to its members. However, if auto-consolidation of accounts does not occur, many of the cost reductions promoted by the review will be illusory.

As there are over 20 million unnecessary accounts floating around the system, it is critical to have a system to stop them proliferating and to encourage consolidation of existing accounts. This should be done on an opt-out basis so that it happens *unless the member indicates that they want to keep the accounts separate*. Some members may have multiple accounts for legitimate reasons, e.g. they may have a risk-only superannuation account for insurance purposes or may have made an active decision to diversify their superannuation benefits by fund - but these will be the extreme exceptions rather than the rule.

One possible reason for this weak recommendation is that many industry funds rely on inactive accounts to subsidise fees for active members. If this source of fees disappeared, the active members would need to pay much more. Cooper has missed an opportunity to promote a more efficient system!

**It is critical to enforce automatic account consolidation or many of the potential cost savings will not eventuate.**

## Costs & Fees

A key intent of MySuper is to cut fees for members and this theme runs through most proposals. The Review has been concerned that costs have not fallen significantly over the last decade and that the industry average of 1.25% of assets should be closer to 1.0% of assets, a 20% reduction. Unfortunately, in addressing this issue, the Review has shown a fundamental lack of understanding of superannuation costs.

The launch of the Final Report contained the claim by Minister Chris Bowen that MySuper “could generate short-run savings of \$550 million a year, rising to \$1.7 billion a year over a longer term. For a worker on average weekly earnings over a career of 37 years the benefit would be the equivalent of a 40 per cent reduction in the fees - or of investing a further 1 per cent of their salary a year in superannuation”. This claim is based on Treasury calculations done for the Cooper Review - with little understanding of the underlying cost structures within superannuation.

Some initiatives will reduce costs, particularly the introduction of SuperStream and the separation of financial advice from product. Continued fund mergers will also lead to savings on investment costs. However, MySuper itself may well lead to an *increase* in costs (as we demonstrate later in this newsletter)!

The Review has relied heavily on a report from a consultant about likely changes in fees on the introduction of MySuper. We disagree with many of the assumptions and logic used. ASFA has summarised its issues on this matter in an Appendix to its submission to the Review of 2<sup>nd</sup> June 2010<sup>3</sup>. We support the ASFA assessment.

### *Trends*

Rice Warner’s work for IFSA on superannuation fees is quoted extensively in the Review’s Final Report. It is used to state (correctly) that overall fees are rising in dollar terms even though they are gradually falling as a percentage of assets under management.

It is worth noting that average fees have fallen in some segments in recent years. One of these is the Corporate Fund Sector. In this case, average fees have fallen as smaller funds have been wound up, leaving mainly lower cost larger funds remaining. This reduction in average costs has masked the fact that fees have actually risen for the remaining funds in this sector (as they have in other segments) due to persistent legislative changes and the demand for higher levels of member services.

Another area where fees have fallen significantly is the corporate master trust sector. Since 2002 the introduction of Financial Services Reform (FSR) and particularly since 2004 (the

<sup>3</sup> [http://www.supersystemreview.gov.au/content/submissions/downloads/ASFA\\_MySuper\\_100602.pdf](http://www.supersystemreview.gov.au/content/submissions/downloads/ASFA_MySuper_100602.pdf)

introduction of APRA RSE licensing of funds), there has been intense competition to gain the superannuation business of large companies as they outsource their funds.

There are many examples of corporations winding up their superannuation and shifting to a sub-plan within an industry fund or master trust. Some have achieved annual reductions in costs of 40 basis points (0.40%) or more per annum which have been passed onto their members.

Jeremy Cooper does not acknowledge this. For example, in a speech to CEDA in May, he tried to explain the reduction in somewhat convoluted terms<sup>4</sup>. Had he asked us, we could have advised him that the growth in funds under management was accompanied by a large growth in the number of accounts too - so the average fees per member did in fact fall.

### *Segmentation of Fees*

At a high level, superannuation costs can be broken into three broad groups covering operational expenses, investments and member engagement services (including financial advice).

Distribution and marketing costs vary by segment and are expressed in different ways which can complicate comparisons.

It is necessary to review these sections separately as the trends in each vary.

### *Operational Expenses*

Despite the Review's assertions, *MySuper* may well lead to increased fees for large groups of members. Further, the emphasis on costs (and not value) could lead to reduced innovation and poorer long-term outcomes.

Conversely, the *SuperStream* proposal from Cooper to force all contributions (and rollovers) to be transmitted electronically with accurate data from employers will dramatically reduce costs in some sectors (particularly industry funds). This is not a new idea and the industry has proposed it for at least the last decade. However, it does need legislation to force employers to comply. The impact on fees will depend on whether this concept is taken further to eliminate the 20 million unnecessary inactive accounts locked up in the system.

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<sup>4</sup> "The corporate master trust market is one where it is sometimes argued that the benefit of rigorous competition does flow directly to members. For example, fees charged by an average large corporate master trust fell from 1.24 per cent in 2002 to 0.79 per cent in 2008, a 36 per cent drop in percentage terms and a figure well below the ideal "one per cent fee" mark touted by regulators prior to the super review."

But Cooper said using the same research (Rice Warner figures), funds under management in the corporate sector grew by roughly 93 per cent over that same period, which means in nominal dollar terms, fees went up, not down, by over 22 per cent.

"Let's be fair and put that in real terms. One option would be to deflate fees by the combination of growth in the number of members and general prices growth," he said. "Even under these assumptions, fees have stayed about the same in this sector".

The other major initiative is that of Minister Bowen's adoption of the Ripoll Review recommendation to separate advice costs from products. This will reduce fees significantly for disengaged members within the retail industry. It will lead to higher fees in some other segments as member engagement services including limited advice are increased.

Operational expenses have not reduced in recent years for several reasons:

- Annual changes to legislation have led to continued work for all participants in the industry ranging from continued changes to disclosure through to systems development;
- There have been major systems upgrades in all sectors to cope with the shift from transactional services to member engagement services;
- There has been a proliferation of inactive accounts with more than 20 million unnecessary ones weighing on the industry<sup>5</sup>;
- There has been a marked increase in governance requirements and costs in many areas;
- Most funds have increased insurance benefits leading to more claims;
- Products have become more complex as funds have positioned themselves in a competitive environment; and
- Paper-based processes still prevail.

On the last point, there is no doubt that SuperStream will lead to significant cost reductions for many funds. The benefits from SuperStream will cut the costs of some industry fund administrators by up to 30%, though many of these savings will be redirected into supporting other areas of their business. There will be negligible savings for public sector funds, corporate funds and some wholesale master trusts where paper-based processes are rare. **The claimed savings of \$1 billion a year in fee reductions will not occur!**

In fact, the non-investment fees for industry funds are likely to *increase* since:

- They will lose inactive accounts under account consolidation which will reduce fee income considerably<sup>6</sup>;
- Their administrators will increase fees as they build more sustainable businesses requiring a return on capital - and as the demand for member engagement services grows.
- They will not be able to take a commission on group insurance policies so will need to charge insured members (but not other members) separately for the costs of running insurance benefits;
- They will need to build operational reserves (see section on *Integrity of the System*). These reserves can only come from higher fees from members, whether expressed as an implicit fee or taken indirectly as a deduction from earnings;
- In addition to operational reserves, funds will need capital to expand services such as intra-fund advice and to expand sales and marketing capacity in a more competitive market;
- The growth of member engagement and the services required to support this;
- The attempt by the Review to eliminate cross-subsidisation means that it will be difficult to charge high marketing and sales costs to MySuper accounts (so other members will pay disproportionately for these) ; and

<sup>5</sup> Inactive accounts are cheaper to run than active accounts and the fees charged exceed the cost of running them. While overall costs will fall with the removal of unnecessary accounts, the fees charged to active accounts will need to rise!

<sup>6</sup> See SuperStream section - auto-consolidation is not recommended by the Review but it is a natural consequence of the other changes and should be legislated.

- Any cost savings will be utilised to deliver increased member engagement services NOT to provide fee reductions for members.

While there are scale advantages for operational costs, these are not unlimited as is the case with investment fees. Smaller, more frugal funds should remain competitive even with slightly higher unit operational costs.

### *Advice & Distribution Costs*

These expenses have not reduced in recent years for several reasons:

- In the commercial sector, the competition for market share has led to higher distribution costs;
- In some areas (such as retail master trusts), future costs will fall significantly as a result of FOFA; and
- Member engagement services (which will continue to grow). These services range from data mining, initiation of campaigns to members, seminars, call centres, websites and expanded intra-fund advice services.

We expect the amount of intra-fund advice to grow five-fold over the next ten years<sup>7</sup>. As funds will be required to provide this service *proactively*, their costs will rise significantly. At present, the provision of these services is extremely price elastic and funds struggle to recover their costs. Most funds are currently prepared to subsidise these services as they lead to better outcomes for their members.

We expect the costs of providing intra-fund advice to continue to rise in the short-term, notwithstanding the benefits from improved technology in delivering simple Statements of Advice electronically.

Under FOFA, commission is to be banned. The review reinforces this and recommends extending this to life insurance too. It requests a two-year transition but no grandfathering<sup>8</sup>. This recommendation would expedite the demise of commissions on small employer master trusts. However, this will happen on SG super anyway as employers would need to switch to a MySuper account (which by definition does not contain commission payments).

An interesting recommendation is that no costs associated with advising employers may be charged to MySuper or Choice members. This is undoubtedly intended to deal with the excessive fees charged in some parts of the small corporate master trust market. In practice, the ban on commissions addresses this problem anyway. The recommendation's impact on industry funds is unclear because they spend considerable resources on servicing employers and this servicing extends to advising them on superannuation. Employers will not pay these costs on top of their SG obligation!

Employers will only be able to use a MySuper account as their default for SG purposes. However, the Cooper Review recommends that the Productivity Commission determine whether to allow **all** MySuper accounts to be available as part of the modern award selection. This would be detrimental to the growth of industry funds since they would lose their distribution monopolies under industrial awards, but would be beneficial to commercial funds and platforms that offer a MySuper product. The main impact of this recommendation would

<sup>7</sup> See Transformation of the Financial Advice Industry  
[http://www.ricewarner.com/images/newsroom/1272413791\\_Transformation%20of%20the%20Financial%20Advice%20Industry.pdf](http://www.ricewarner.com/images/newsroom/1272413791_Transformation%20of%20the%20Financial%20Advice%20Industry.pdf)

<sup>8</sup> The FOFA proposal allows for grandfathering of commissions in place before July 2012.

be to increase the costs of industry funds significantly as they would need to defend their position against commercial funds.

### *Investment Costs*

Global experience shows that, other things being equal, investment costs fall as a percentage of assets as the overall size of the fund grows. Investment costs have fallen as the Australian superannuation system has grown but the reduction has been tempered by a shift into assets with higher underlying costs, including infrastructure, private equity and hedge funds. The proliferation of investment choice has not helped as this reduces the size of mandates within a fund (and fees are higher for smaller mandates).

Several larger funds now invest directly in property which also has high costs relative to (say) direct equities.

Another cause of increased costs has been the shift towards performance-based fees. It is clear that, in the past, many funds have not set sufficient hurdles for obtaining these and the review recommends that APRA set a standard for the future. This may not be as easy as it sounds and it could lead to higher fixed investment fees.

There appears to be an unstated principle in the Cooper Report that all cost reductions are beneficial for members. However, in the case of investment costs, the net return is what matters to members. The review emphasises this with its focus on returns after fees and taxes. There is a potential danger that an excessive focus on costs will drive MySuper products to a race for low-cost outcomes even if this does not maximise long term returns. It would be appalling if products use Cash as a default strategy in order to cut explicit fees!

### *Scale Benefits*

The Review appears to believe that increased scale is the mechanism to reduce costs. While this has some merit, particularly with investment costs, the solution chosen is impractical - it is recommended that APRA will review scale annually to ensure it is “sufficient<sup>9</sup>” for a fund to provide good value.

This suggestion extends the role of a regulator dangerously. Does this mean that every corner shop is non-viable because they charge more than Coles and Woolworths? Even if they provide a dearer service, albeit more personalised, is it the government’s job to decide on their business economics and put them out of business?

It should be noted that some smaller funds already pool investments with other funds to get the benefit of scale. We expect that many funds will find this to be a more attractive option than winding up.

Finally, there has been considerable rationalisation of funds for the last 15 years. It is true that many smaller funds should consider merging more seriously than they do, but market forces have already eliminated two-thirds of industry funds and more than 95% of corporate funds in that time. Legislation is not needed to interfere with existing market forces.

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<sup>9</sup> It is not helpful that the Review does not define “sufficient scale”

## Trustee Governance

It is recommended that a new entity called trustee-director be codified in law and it recommends an unspecified minimum level of trustee training. It is also keen to have Board representation of “non-associated” persons. We agree that this is important in public offer funds as members joining under Choice and all pensioners lack direct Board representation.

The Review recommends a majority of “non-associated” persons in funds which do not have equal representation of employees and employers. For example, that would require a commercial fund to have non-executives controlling its superannuation trustee Board.

Where equal representation does apply, such as industry funds, it recommends that one-third of the employer and member representatives be non-aligned. In theory, this would reduce the monopoly of the founders of the fund, namely the trade unions and employer associations. In practice, the Board would simply nominate people who have similar sympathies and objectives. The HOSTPLUS Board structure is a good example of how this system works in practice.

The Panel stopped short of recommending trustees not serve on two or more Boards of public-offer funds. It suggested instead that trustees in this position should need to convince APRA (and the funds’ Boards) that they do not have a conflict of interest.

The Panel noted that a goal of having 40% of women as directors would be “in keeping with emerging international best practice”. In fact, gender imbalances are a global problem so this recommendation is more in keeping with contemporary thought than any shortfall in local standards.

We strongly support this recommendation though it should be re-worded to state that Boards should have at least 40% male and 40% female trustee directors. Note that a Board of 7 will have to have at least 3 females and a Board with 9 will need at least 4 females. However, Boards introducing this standard will need to set up Alternate Trustee Directors so there is a quorum if one female trustee is absent for a meeting.

## Investments

In addition to cost savings, the Review makes other recommendations relating to investments. The key ones are:

- Investment performance should be measured on an after-tax basis and disclosed over periods of 1, 5 and 10 years;
- Valuations of assets must also be reasonable and determined at arm’s length;
- Full details of the individual investment holdings in the portfolios of each option must be shown on a six-monthly basis (but published some time after the date as the information is market sensitive); and
- Environmental, Social and Corporate Governance (ESG) issues should be “considered”. The Panel obviously did not want to set a standard in this emerging field.

### *Investment Performance*

Investment performance is critical in providing good retirement outcomes for members. However, it is well known that past performance is no guide to future performance. It can be helpful, for example, in three areas:

- Observation of poor performance is useful in eliminating fund managers which consistently perform below average (as no one wants to invest in persistently poor outcomes);
- It is a statistical measure to test whether the fund is achieving the benchmarks set for asset classes or investment strategies (options); and
- It can be used to monitor the performance of the industry as a whole. For example, if the industry consistently earns real returns above the growth in wages, then it is worthwhile pre-funding retirement benefits.

Apart from the above, it is not possible to rank funds on the basis of investment performance alone. A full analysis needs to take account of:

- Investment risk as well as returns;
- The impact of different investment strategies (how will these be measured against peers?); and
- The variation in investment objectives.

On the last point, some funds will target a lower return in the knowledge that this will reduce risks and volatility of returns. Any peer comparison should take the stated objective into account.

Noting that investment performance is used extensively in marketing and can be highly misleading, we find it bizarre that the Review recommends that APRA continue with its (meaningless) whole-of-fund comparisons supplemented by comparisons of MySuper products as they are developed.

The more useful reporting of investment returns at the portfolio level is recommended to be the obligation of individual funds, but this reporting is subject to a common standard to be developed by APRA. A further recommendation is that government (the agency is not named) should develop an investment option performance table for MySuper and choice investment options - which sounds suspiciously like APRA actually collecting and publishing investment performance results for the industry.

### *After-tax returns*

The Panel wants to show investment performance after fees and taxes for MySuper products. While it is sensible to know that fees and taxes are deductions from the account, it is not always fair to compare funds on a net basis. For example, many public sector funds are partly unfunded and they are taxed differently.

Further, tax is applied across the whole of a superannuation fund, not just the earnings of the fund. The Review has set out a table for the mandatory disclosure of investment performance information<sup>10</sup>. It has separated the tax on assessable contributions from the tax on earnings but it makes no allowance for other deductible items such as administration fees or insurance premiums. It also ignores imputation credits which will reduce tax on other items.

Apart from the simple errors in the table, we question what value it is to provide this level of disclosure to members!

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<sup>10</sup> Final Report Part 2 - Table 4.1 (page 113)

In our opinion, past investment performance is of little value to a member. In fact, it may deceive them into investing in an inappropriate strategy. It is far more useful to show the investment strategy for an option and to give a guide as to whether the trustee has achieved this in the past within a reasonable risk profile.

It is not the role of a regulator to publish investment performance results for individual funds. APRA's whole-of-fund results are clearly nonsensical since members do not invest in any weighted average portfolio. Further, it provides no analysis of risks, rendering the results meaningless.

## Outcomes Transparency

In addition to the disclosure of investments above, there would be other disclosure to members. The key matters are:

- APRA will appoint a consultant to benchmark industry costs;
- APRA will construct a product *dashboard* for each investment strategy (option). This would show expected return as well as the likely volatility of results;
- Fund websites will need to contain much more information about the fund including archive copies of obsolete documents. This seems a bit excessive given the view of the Review that disclosure does not work as most people are disengaged!
- Funds would disclose the Total Annual Expense Ratio (TAER), which is basically a new name for a Management Expense Ratio!

On the last point, the Review appears to have trawled the world hastily looking for appropriate means of disclosing information on fees and returns to members. Consequently, they recommend a Standardised Disclosure Label based on the Squam Lake Working Group Model<sup>11</sup>. Clearly, though, this example is poorly drafted and would be incomprehensible to the average member.

## Insurance

The section starts by noting that *most Australians do not have life or TPD insurance cover outside superannuation*. This reflects the growth of insurance benefits within superannuation over the last five years as an industry initiative to overcome the Australian under-insurance problem. Despite the tax benefits from placing insurance within superannuation, our Risk Projections Report shows that 56% of all life insurance is actually sold outside superannuation.

### *Levels of Insurance Cover*

The Review recommends removing the current minimum mandatory level of cover. This is set at a level costing about 50 cents a week per member which is far below contemporary levels of cover. Instead, trustees would decide on the appropriate level of cover for their members.

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<sup>11</sup> Final Report Part 2 - page 132

The Review implies that there should be some insurance in MySuper but appears ambivalent as to whether there should be any in Choice products. The changes could allow some funds to avoid having any insurance but most funds are unlikely to remove it given the good value provided by group insurance.

The Review seemed to be confused between the lump sum Total and Permanent Disability (TPD) benefit and Income Protection, which involves a series of periodic payments while disabled. It makes the unfortunate error of stating that TPD benefits are offset by workers compensation, sick leave and Centrelink benefits. In fact, it is Income Protection where offsets apply.

Its uncertainty over Income Protection leads the Review to recommend that this form of cover should continue as a permissible fund benefit but trustees should decide whether to offer it or not. There is no commentary on the integration of TPD and Income Protection payments or whether it considers short or long term benefit periods to be desirable.

Finally, the Review recommends that no other insurance apart from death, TPD or Income Protection may be permitted. This would rule out the provision of trauma insurance through superannuation.

### *Commission*

As expected, it is recommended that commission on life insurance should be prohibited. However, this will mean that funds cannot take a slice of the premium to cover administration of insurance (or to subsidise fees generally). Some funds take up to 10% of the premium at present.

They could still charge a fee for insurance services but the presentation would change. For example, a premium of \$3 a week which includes a 10% commission would have to be re-expressed as a premium of \$2.70 with 30c a week added to the fee of insured members.

There is no comment on profit-sharing. Some people (incorrectly) consider this to be a commission so it may also be outlawed - which would be a backward step for the industry.

### *Profitability of Life Insurance*

The Panel repeats the assertion made in a preliminary report that claims are only about 43% of premiums, implying that funds are paying too much for insurance. The reasons for this (which are not stated in the report) are:

- There is a lag between payment of premiums and receipt of claims, especially for disability claims - so any single year analysis is misleading.
- Premiums include an allowance for costs including underwriting, claims management and administration;
- Many funds receive profit shares which are excluded from the ratio;
- Some retail platforms pay commissions to advisers (which will soon be banned);
- Many funds take an administration fee (which is technically a commission) from the insurer to pay the costs of providing insurance benefits;
- Insurers need to set up reserves, which is a major impost in a rapidly growing segment; and
- Mortality and morbidity rates are falling so premiums have turned out to be higher than necessary - leading to significant reductions in premium rates on review (reductions of up to 40% have been gained in recent insurance tenders).

From the insurance tenders we conduct, we know that the Australian life insurance market is competitive and provides good value for members. The analysis on profitability is sub-standard and should not have been included in the final report.

### *Self-insurance*

Notwithstanding that the Review considers life insurance to be too profitable, it wants all self-insurance to be phased out!

This recommendation is a risk management measure, though self-insured pools can still buy protection through catastrophe cover and most are well managed, and monitored by APRA.

## Integrity of the System

This section looks at security within the system and recommends the following:

- Funds will need to hold an operational risk reserve. Within the industry, a level of about 0.5% of assets has been suggested as a guide. Rules will need to be set for moving money into and out of operational reserves;
- Trustees will need to manage liquidity risk for the fund as a whole and for each investment option. Liquidity will become a major issue as the amount of unlisted assets grows (and as the number of pensioners grows). The fact that each option must be liquid means that funds cannot use the Balanced (default) option as the cash account for other options. Some options with small FUM may need to be closed;
- Strengthening of reserves for defined benefit funds; and
- There will be licensing of administrators and clearing houses. The large administrators won't mind being licensed - though some of the smaller ones may not qualify. The Clearing Houses may struggle too - but they do hold significant cash on behalf of clients and these funds need to be protected.

It is unclear whether:

- Self-administered funds will need to hold a licence for this activity; and
- The administrators of SMSF funds should also be licensed.

## Retirement Products

Like the Henry Review, Cooper tentatively recommends income-stream products, but has not been able to suggest the likely form of the product.

### *MySuper*

There is a recommendation for a mandatory retirement-income stream product. This is extremely poor public policy. By definition, most of the MySuper account holders will end up on a full Age Pension. Forcing them to take an income stream on small super balances does not impact on government revenue - but it negates one of the real advantages of SG super which is to give low income Australians a small lump sum on retirement.

### *Benefit Projections*

For reasons we cannot fathom, all MySuper accounts will need to provide annual Benefit Projections. Most of these will not be read, which is fortunate as the prescribed format will not be useful to members (we do however, support mandatory annual benefit projections for Choice members).

The fundamental flaw is that the projections exclude the impact of the Age Pension. As most MySuper members will receive a full or part Age Pension, the projections would be meaningless. Worse, in some cases, means-testing will reduce a member's entitlement so the statements will be misleading for those who think they will get a full Age Pension in addition to their superannuation.

There is also a recommendation to take longevity risk into account in setting the investment strategy for pensioners within MySuper accounts. It is unclear how this can be done for people in account-based pensions (as most will continue to be). Trustees "*must devise a separate investment strategy for post-retirement members in MySuper*" taking into account inflation and longevity risk.

Again, this is a naïve recommendation! Longevity risk is not an issue *for the majority of Australians* who retire with small benefits (less than \$200,000). Inevitably, they will spread their benefit over the first 10 to 15 years of retirement when they are active. Later, when sedentary or frail, they will revert to the Age Pension as their sole income support.

The Panel recommends providing intra-fund advice to MySuper members proactively leading up to retirement and then periodically during retirement. This will be challenging (as the members are disengaged) and costly.

**We regard the material on retirement incomes to be extremely weak and strongly recommend to government that it seeks a better solution by consultation with the industry.**

## Conclusions

The Cooper Review has undertaken a considerable amount of work in a relatively short time. It provides enough information to reform much of the existing system and to remove many inefficiencies. However, it needs to be analysed carefully as the recommendations vary in quality. In summary:

### *The Good*

- SuperStream will finally deliver electronic commerce;
- Commission will be banned;
- Proposed Trustee governance standards;
- Improved security from:
  - Operational reserves;
  - Liquidity management; and
  - Licensing of administrators and clearing houses.

### *The Bad*

- The requirement to provide Income-stream products for MySuper account holders;
- Compulsory Benefit Projections without taking the Age Pension into account (rendering the projections largely meaningless for most members);
- Ignorance on industry cost structures - 40% fee reduction for the average member simply won't happen; and

- The Review missed the opportunity to recommend automatic consolidation of accounts to prevent the proliferation of unnecessary accounts.

### *The Ugly*

- MySuper - good idea but proposal is over engineered and unnecessarily costly;
- Using Squam Lake as a basis to improve disclosure;
- Wrong formula for after-tax investment performance;
- Supports APRA's irrational whole-of-fund investment performance;
- Life insurance - very poor chapter of little value.

As John Maynard Keynes is alleged to have said

*"When the facts change, I change my mind. What do you do, sir?"*

We recommend that the government desist from the claims made about likely cost reductions and improvements in efficiency. It should consult widely with industry to modify the proposals along the lines we have set out in this special newsletter. Then, real significant improvements will be made.

**Rice Warner is holding a series of executive briefings with the goal of evaluating the potential threats and opportunities that will no doubt arise for our clients as a result of the Cooper Review. We are able to assist clients in deciding their strategic response in terms of product design, pricing, member engagement, advice models, distribution and governance.**

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